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# FRBSF WEEKLY LETTER

October 26, 1990

## Banking Performance

Concern over deteriorating asset quality, especially real estate-backed assets, has dominated the news about the banking industry recently. As nonperforming loans have risen and industry-wide earnings have fallen, several major banks have announced massive reductions in staff and increased reserves against future losses.

Reflecting investors' concerns, bank stock prices have fallen dramatically. In percentage terms, Salomon Brothers' 35-bank index has fallen about three times faster than the broader S&P 500. Moreover, a recent survey by the *American Banker* revealed that 35 percent of the public considers the banking system "unhealthy," the poorest rating since the survey began in 1984.

In this *Letter* some of the concerns about the banking industry are explored. Western banks are faced with many of the same problems as banks elsewhere. However, with the exception of Arizona, their performance has been strong, and most indicators of asset quality remain favorable. Even so, stock prices of major western banks have fallen along with the stock prices of the rest of the industry.

### A long list

The list of worries facing bankers in 1990 is a long one. Currently at the head of the list is the continued deterioration of the real estate market, especially for commercial properties and for construction and land development projects. Problems in real estate markets have been particularly acute in New England, Texas, and Arizona, where even housing prices have fallen.

As a result of weakening real estate markets, the banking industry is reporting a rise in past due and nonperforming real estate loans, from an average of about five percent of the total over the prior five years to over six percent currently. Loans "charged off" as uncollectible also have

risen, to 0.7 percent for the first half, nearly double the average for the prior five years.

Not only is the quality of real estate assets a concern, but the *quantity* has become a concern as well, as real estate loans outstanding have doubled since 1984, and the share of real estate loans in bank portfolios has increased dramatically. The increase in banks' exposure to real estate loans partly reflects a decline in their role as commercial lenders. Business loans outstanding have grown only 20 percent in the last five years, as major corporate customers have reduced their borrowing from banks in favor of raising funds directly in the commercial paper and long-term debt markets. In addition, intense competition from foreign banks has tended to curtail U.S. banks' role in commercial lending.

Another concern is the course of the economy and its impact on the quality of business loans. Banks now hold relatively fewer commercial credits of top-rated, lower-risk, corporate borrowers and more loans to both middle market and highly leveraged borrowers that are more likely to be sensitive to cyclical downturns. Should the economy slow appreciably and firms experience cash flow problems, commercial loan quality could deteriorate significantly.

Many money center banks are also concerned about their still-sizeable exposure to less developed country (LDC) loans, especially if the situation in the Middle East begins to have an adverse impact on non oil-producing LDCs. Finally, with personal bankruptcies at a record level, and consumer loan charge offs up slightly, consumer loan quality is another concern.

### Industry performance

The performance of the banking industry in the first half of 1990 reflected these problems. Bank earnings were 18 percent lower than in the first half of 1989, and the return on assets (ROA) fell

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## WESTERN BANKING

*Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

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from 0.90 to 0.70. (Although ROA slipped, 0.70 still exceeds the industry average for the prior decade.) This decline also suggests that although banks have attempted to reduce staff, these cost savings have not been fully realized yet. At the same time, higher overhead expenses associated with monitoring problem loans actually have raised overhead costs.

In addition to higher overhead expenses, banks' net interest margin (NIM), which measures the difference between the return banks receive on their assets and the cost of funding those assets, declined several basis points to 3.42 percent. This reflected a shift to relatively more expensive time deposits for funding.

Sluggish asset growth also tended to constrain income growth this year. Faced with the need to raise additional capital and improve asset quality, banks were forced to curtail lending; in the first half of this year, assets grew less than 1½ percent, about half of the growth rate in 1989.

## **The West: better**

Through the first half, bank performance in the West contrasted sharply with the deterioration seen elsewhere in the nation. Earnings at western banks increased 16 percent over the first half of 1989 and ROA rose to 1.19 from 0.91 percent. Performance throughout the region was favorable, as first half earnings rose in all the western states except Arizona. Even in Arizona improvement was notable; losses were down substantially.

Continued growth in the western economy, which spurred loan growth and kept asset quality at a high level, largely accounts for the favorable earnings picture. Unlike the experience nationally, western banks' assets have expanded rapidly in recent months. Even ignoring the \$5 billion in assets gained through acquisitions of S&Ls, western banks' assets grew by over \$18 billion, or at an eight percent annual rate.

Much of this growth was real-estate related. In fact, even though real estate markets in the West began to cool off at the end of last year, western banks' real estate lending continued to grow rapidly during the first half and into the third quarter of this year. Real estate loans increased at annual rates of 22 and 28 percent for the region and California, respectively. Residential mortgages and home equity lines of credit rose even faster than did total real estate loans, al-

though some of the increase also reflects funding for commercial projects already in the pipeline before the slowdown.

On account of this rapid growth, western banks' real estate loans now amount to over 43 percent of total loans, well above the nationwide average of 37 percent. California has an even higher share, at 46 percent.

Such a large concentration of real estate loans is a source of concern. Fortunately, however, the types of real estate loans held by banks in California and the West are not as risky as those held by banks in regions that are experiencing difficulties. California banks hold more than half of their real estate loans in relatively low-risk residential loans. This is well above the national average. At the same time, California banks hold only about a 23 percent share of commercial real estate loans, compared to over 29 percent nationally and 30 to 40 percent in Texas and New England, where overbuilt commercial real estate markets have been a cause of significant deterioration in real estate loan quality.

And although California banks hold a higher share of construction and land development loans than is the case nationally, the California economy and the West in general are much less dependent on the construction industry than is true of the regions where risky construction loans have exhibited poor performance.

Finally, in the West, the most recent data provide no indication that the quality of either commercial or real estate loans has begun to deteriorate. On the contrary, the ratio of net charge-offs to total loans and leases has *fallen* slightly for large western banks' real estate and commercial loans. Likewise, the ratios of past due real estate and commercial loans to total loans have fallen.

## **Investor concerns**

In spite of such a strong performance, the stock prices of western banks have fallen sharply along with those of banks elsewhere. Nervous investors apparently have downplayed the favorable performance of the industry in this region, and have concentrated on the potential spread of asset quality deterioration and uncertainty about the extent of further slowing in the economy. Thus, although most western banks have weathered the slowdown in the economy better than the industry in general, they are not exempt from industry- and economy-wide concerns.

**Gary C. Zimmerman**  
Economist

# REGIONAL BANK DATA

JUNE 30, 1990

(Not Seasonally Adjusted, Preliminary Data)

|   |                     | DISTRICT | ALASKA | ARIZ.  | CALIF.  | HAWAII | IDAHO | NEVADA | OREGON | UTAH   | WASH.  |
|---|---------------------|----------|--------|--------|---------|--------|-------|--------|--------|--------|--------|
| ASSETS AND LIABILITIES-- \$ MILLION (ALL COMMERCIAL BANKS)              |                     |          |        |        |         |        |       |        |        |        |        |
| ASSETS  | TOTAL               | 487,539  | 4,312  | 30,329 | 338,145 | 16,947 | 8,336 | 14,961 | 23,060 | 11,528 | 39,919 |
|   | FOREIGN             | 41,152   | 0      | N/A    | 38,464  | 2,256  | N/A   | N/A    | N/A    | 71     | 361    |
|   | DOMESTIC            | 446,387  | 4,312  | 30,329 | 299,681 | 14,691 | 8,336 | 14,961 | 23,060 | 11,457 | 39,558 |
| LOANS   | TOTAL               | 348,777  | 1,922  | 19,911 | 248,369 | 9,641  | 5,601 | 11,215 | 15,746 | 7,489  | 28,883 |
|   | FOREIGN             | 33,140   | N/A    | N/A    | 31,980  | 1,034  | N/A   | N/A    | N/A    | N/A    | 127    |
|   | DOMESTIC            | 315,637  | 1,922  | 19,911 | 216,389 | 8,607  | 5,601 | 11,215 | 15,746 | 7,489  | 28,757 |
|   | REAL ESTATE         | 150,506  | 755    | 7,074  | 114,463 | 4,143  | 1,506 | 2,275  | 4,991  | 2,970  | 12,330 |
|   | COMMERCIAL          | 77,038   | 695    | 3,784  | 51,919  | 2,559  | 1,453 | 1,669  | 5,556  | 1,787  | 7,617  |
|   | CONSUMER            | 57,766   | 282    | 5,173  | 31,536  | 1,313  | 1,549 | 6,821  | 3,293  | 2,041  | 5,759  |
|   | AGRICULTURE         | 5,678    | 5      | 458    | 2,829   | 43     | 677   | 21     | 405    | 136    | 1,104  |
|   | INTERNATIONAL       | 378      | N/A    | 12     | 359     | 0      | N/A   | N/A    | 6      | N/A    | 0      |
| SECURITIES  | TOTAL               | 43,238   | 1,754  | 3,911  | 21,226  | 3,388  | 1,630 | 1,869  | 3,712  | 2,078  | 3,669  |
|   | U.S.T.S.            | 13,056   | 1,090  | 1,320  | 5,927   | 1,001  | 464   | 672    | 903    | 517    | 1,162  |
|   | SECONDARY MARKET    | 18,437   | 255    | 1,510  | 10,051  | 1,540  | 686   | 499    | 1,605  | 1,052  | 1,238  |
|   | OTHER SEC.          | 11,745   | 409    | 1,080  | 5,248   | 847    | 480   | 698    | 1,204  | 509    | 1,269  |
| LIABILITIES   | TOTAL               | 457,195  | 3,850  | 28,325 | 317,892 | 15,975 | 7,789 | 13,912 | 21,470 | 10,739 | 37,243 |
|   | DOMESTIC            | 416,043  | 3,849  | 28,325 | 279,428 | 13,719 | 7,789 | 13,912 | 21,470 | 10,668 | 36,882 |
| DEPOSITS  | TOTAL               | 385,828  | 3,317  | 26,002 | 267,449 | 15,143 | 6,559 | 8,315  | 17,776 | 9,169  | 32,097 |
|   | FOREIGN             | 35,249   | 0      | N/A    | 32,700  | 2,109  | N/A   | N/A    | N/A    | 71     | 369    |
|   | DOMESTIC            | 350,578  | 3,317  | 26,002 | 234,749 | 13,034 | 6,559 | 8,315  | 17,776 | 9,098  | 31,728 |
|   | DEMAND              | 81,531   | 979    | 4,750  | 58,281  | 2,335  | 1,077 | 2,096  | 3,407  | 1,722  | 6,885  |
|   | TIME AND SAVINGS    | 269,047  | 2,338  | 21,252 | 176,468 | 10,699 | 5,482 | 6,219  | 14,369 | 7,377  | 24,844 |
|   | NOW                 | 32,602   | 233    | 2,269  | 20,760  | 1,258  | 746   | 870    | 2,246  | 1,075  | 3,145  |
|   | MMDA                | 65,926   | 408    | 4,768  | 45,053  | 2,107  | 1,040 | 1,784  | 3,206  | 1,484  | 6,074  |
|   | SAVINGS             | 31,774   | 357    | 1,311  | 22,449  | 1,419  | 383   | 858    | 1,412  | 812    | 2,773  |
|   | SMALL TIME          | 78,535   | 697    | 10,196 | 44,021  | 1,781  | 2,629 | 1,239  | 5,585  | 3,065  | 9,321  |
|   | LARGE TIME          | 59,766   | 626    | 2,692  | 43,892  | 4,132  | 666   | 1,468  | 1,910  | 938    | 3,442  |
| OTHER BORROWINGS  |                     | 48,636   | 487    | 1,729  | 32,093  | 388    | 1,147 | 4,810  | 3,055  | 1,407  | 3,521  |
| EQUITY CAPITAL  |                     | 30,344   | 463    | 2,004  | 20,253  | 973    | 547   | 1,049  | 1,590  | 789    | 2,676  |
| LOAN LOSS RESERVE   |                     | 7,584    | 41     | 693    | 5,642   | 146    | 90    | 205    | 218    | 146    | 404    |
| LOAN COMMITMENTS  |                     | 199,592  | 561    | 9,902  | 151,402 | 7,080  | 2,102 | 2,168  | 7,773  | 2,874  | 15,730 |
| LOANS SOLD  |                     | 61,469   | 42     | 525    | 59,762  | 54     | 38    | 187    | 397    | 64     | 401    |
| ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)              |                     |          |        |        |         |        |       |        |        |        |        |
| LOAN LOSS RESERVE (ALL BANKS)   |                     | 2.17     | 2.14   | 3.48   | 2.27    | 1.51   | 1.60  | 1.83   | 1.38   | 1.95   | 1.40   |
| NET CHARGEOFFS, TOTAL   |                     | 1.14     | 0.47   | 1.74   | 1.20    | 0.03   | 0.20  | 3.06   | 0.53   | 0.80   | 0.49   |
| REAL ESTATE   |                     | 0.22     | 0.79   | 1.35   | 0.12    | -0.01  | 0.06  | 0.41   | 0.27   | 0.52   | 0.46   |
| COMMERCIAL  |                     | 0.54     | 0.09   | 3.74   | 0.43    | -0.09  | 0.19  | 1.18   | 0.47   | 1.07   | 0.18   |
| CONSUMER  |                     | 1.98     | 0.42   | 2.18   | 1.86    | 0.38   | 0.55  | 4.46   | 1.18   | 1.25   | 0.95   |
| AGRICULTURE   |                     | -0.42    | N/A    | -0.02  | -1.2    | -0.03  | -0.15 | -0.02  | 0.52   | 0.42   | 1.14   |
| PAST DUE & NON-ACCRUAL, TOTAL   |                     | 4.14     | 5.56   | 8.73   | 4.09    | 0.93   | 1.66  | 6.15   | 2.34   | 3.71   | 3.04   |
| REAL ESTATE   |                     | 3.68     | 8.15   | 15.5   | 3.03    | 0.71   | 1.81  | 3.57   | 3.02   | 4.99   | 4.02   |
| COMMERCIAL  |                     | 5.02     | 5.53   | 12.6   | 5.42    | 0.68   | 1.77  | 3.44   | 2.16   | 4.18   | 2.61   |
| CONSUMER  |                     | 3.12     | 1.80   | 2.19   | 2.80    | 1.96   | 1.51  | 7.87   | 1.47   | 2.32   | 1.81   |
| AGRICULTURE   |                     | 6.74     | 43.2   | 14.4   | 7.65    | 5.02   | 2.62  | 0.81   | 4.88   | 1.90   | 3.98   |
| EARNINGS AND RETURNS -- \$ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS) |                     |          |        |        |         |        |       |        |        |        |        |
| INCOME  | TOTAL               | 27,074   | 222    | 1,478  | 18,830  | 819    | 433   | 1,319  | 1,201  | 615    | 2,157  |
|   | INTEREST            | 22,448   | 190    | 1,217  | 15,460  | 729    | 385   | 1,101  | 1,038  | 542    | 1,785  |
|   | FEES & CHARGES      | 1,168    | 10     | 78     | 802     | 18     | 21    | 28     | 68     | 32     | 111    |
| EXPENSES  | TOTAL               | 22,957   | 181    | 1,507  | 15,833  | 675    | 364   | 1,060  | 996    | 541    | 1,800  |
|   | INTEREST            | 12,435   | 98     | 702    | 8,652   | 425    | 221   | 492    | 570    | 307    | 967    |
|   | SALARIES            | 4,253    | 41     | 301    | 2,986   | 127    | 57    | 97     | 194    | 84     | 367    |
|   | LOAN LOSS PROVISION | 1,466    | 4      | 167    | 936     | 12     | 6     | 180    | 50     | 32     | 79     |
|   | OTHER               | 4,803    | 37     | 337    | 3,260   | 111    | 80    | 292    | 182    | 118    | 387    |
| INCOME BEFORE TAXES   |                     | 4,096    | 41     | -29    | 2,979   | 144    | 69    | 258    | 205    | 72     | 356    |
| TAXES   |                     | 1,417    | 10     | -12    | 1,083   | 51     | 22    | 90     | 62     | 21     | 90     |
| NET INCOME  |                     | 2,816    | 31     | -17    | 2,026   | 93     | 48    | 169    | 143    | 51     | 272    |
| ROA (%)   |                     | 1.19     | 1.47   | -0.12  | 1.23    | 1.13   | 1.18  | 2.11   | 1.28   | 0.90   | 1.42   |
| ROE (%)   |                     | 18.6     | 13.5   | -1.7   | 20      | 19.1   | 17.5  | 32.2   | 17.9   | 13     | 20.4   |
| NET INTEREST MARGIN (%)   |                     | 4.24     | 4.31   | 3.72   | 4.15    | 3.72   | 4.06  | 7.62   | 4.19   | 4.15   | 4.27   |

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## MARKET SHARE STATISTICS

DEPOSITORY INSTITUTIONS REQUIRED TO HOLD RESERVES WITH THE FEDERAL RESERVE ON A WEEKLY BASIS

PERCENT OF COMBINED MARKET TOTAL FOR AUGUST 1990, BY REGION

|                | DISTRICT |    |    | ALASKA |    |    | ARIZONA |    |    | CALIF |    |    | HAWAII |    |    | IDAHO |    |    | NEVADA |    |    | OREGON |    |    | UTAH |    |    | WASH |    |    |
|----------------|----------|----|----|--------|----|----|---------|----|----|-------|----|----|--------|----|----|-------|----|----|--------|----|----|--------|----|----|------|----|----|------|----|----|
| DEPOSIT TYPE   | CB       | SL | CU | CB     | SL | CU | CB      | SL | CU | CB    | SL | CU | CB     | SL | CU | CB    | SL | CU | CB     | SL | CU | CB     | SL | CU | CB   | SL | CU | CB   | SL | CU |
| TOTAL DEPOSITS | 50       | 46 | 5  | 74     | 4  | 22 | 69      | 25 | 5  | 44    | 52 | 4  | 67     | 28 | 5  | 87    | 10 | 3  | 70     | 28 | 3  | 71     | 23 | 6  | 78   | 10 | 12 | 56   | 36 | 7  |
| DEMAND         | 92       | 4  | 4  | 99     | 0  | 1  | 92      | 2  | 5  | 92    | 4  | 4  | 92     | 1  | 7  | 99    | 1  | 0  | 95     | 1  | 4  | 92     | 3  | 5  | 92   | 3  | 5  | 92   | 5  | 3  |
| NOW            | 63       | 30 | 7  | 60     | 5  | 35 | 81      | 10 | 9  | 58    | 36 | 6  | 71     | 26 | 3  | 88    | 9  | 3  | 79     | 15 | 6  | 79     | 14 | 7  | 83   | 5  | 12 | 64   | 24 | 12 |
| SAVINGS        | 48       | 34 | 18 | 35     | 3  | 62 | 54      | 16 | 30 | 48    | 39 | 13 | 47     | 35 | 18 | 76    | 12 | 12 | 70     | 19 | 10 | 55     | 26 | 19 | 57   | 6  | 37 | 45   | 21 | 34 |
| MMDA           | 67       | 31 | 2  | 90     | 8  | 2  | 85      | 14 | 1  | 62    | 36 | 2  | 81     | 19 | 0  | 94    | 6  | 0  | 82     | 16 | 2  | 84     | 13 | 4  | 83   | 7  | 10 | 69   | 29 | 2  |
| SMALL TIME     | 31       | 66 | 3  | 76     | 8  | 15 | 58      | 39 | 3  | 23    | 74 | 3  | 41     | 56 | 3  | 84    | 14 | 2  | 47     | 51 | 2  | 57     | 39 | 5  | 74   | 16 | 10 | 43   | 52 | 4  |
| LARGE TIME     | 43       | 55 | 2  | 94     | 3  | 3  | 71      | 26 | 3  | 38    | 60 | 2  | 82     | 16 | 2  | 86    | 11 | 4  | 70     | 30 | 0  | 83     | 13 | 4  | 81   | 12 | 7  | 50   | 50 | 1  |

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVINGS BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

## INTEREST RATES ON DEPOSITS AND LOANS AS OF AUGUST 1990 (%)

| TYPE OF ACCOUNT OR LOAN           | DATE               | US    | DISTRICT | ARIZ  | CALIF | HAWAII | IDAHO | OREGON | UTAH  | WASH  |
|-----------------------------------|--------------------|-------|----------|-------|-------|--------|-------|--------|-------|-------|
| MONEY MARKET DEPOSIT ACCOUNTS     | JUN90              | 6.31  | 6.24     | 5.85  | 6.47  | 5.69   | 6.04  | 6.56   | 6.10  | 6.39  |
|                                   | JUL90              | 6.28  | 6.22     | 5.82  | 6.43  | 5.69   | 6.03  | 6.49   | 6.33  | 6.32  |
|                                   | AUG90              | 6.23  | 6.18     | 5.76  | 6.30  | 5.69   | 5.95  | 6.53   | 6.34  | 6.32  |
| 92 TO 182 DAYS CERTIFICATES       | JUN90              | 7.81  | 7.40     | 7.33  | 7.77  | 6.66   | 7.61  | 7.37   | 7.71  | 7.16  |
|                                   | JUL90              | 7.73  | 7.34     | 7.30  | 7.76  | 6.79   | 7.50  | 7.32   | 7.67  | 7.22  |
|                                   | AUG90              | 7.64  | 7.25     | 7.13  | 7.58  | 6.79   | 7.48  | 7.29   | 7.51  | 7.25  |
| 2-1/2 YEARS AND OVER CERTIFICATES | JUN90              | 8.00  | 7.85     | 7.55  | 7.95  | 8.00   | 8.01  | 7.95   | 8.06  | 7.72  |
|                                   | JUL90              | 7.94  | 7.75     | 7.52  | 7.88  | 7.81   | 7.96  | 7.93   | 8.05  | 7.69  |
|                                   | AUG90              | 7.89  | 7.62     | 7.39  | 7.74  | 7.77   | 7.93  | 7.64   | 7.88  | 7.71  |
| COMMERCIAL, SHORT-TERM*           | AVE. RATE          | 9.72  | 10.24    | 10.09 | 10.30 | 10.43  | 11.92 | 10.05  | 10.42 | 10.01 |
|                                   | AVE. MAT. (DAYS)   | 49    | 166      | 73    | 264   | 90     | 105   | 170    | 167   | 159   |
| COMMERCIAL, LONG-TERM*            | AVE. RATE          | 10.72 | 11.18    | 10.90 | 11.39 | 11.28  | N/A   | N/A    | 12.15 | 9.25  |
|                                   | AVE. MAT. (MONTHS) | 42    | 27       | 27    | 21    | 26     | N/A   | N/A    | 38    | 62    |
| LOANS TO FARMERS*                 | AVE. RATE          | 10.95 | 9.93     | 10.54 | 9.64  | 9.88   | 11.36 | 10.64  | 12.39 | 11.13 |
|                                   | AVE. MAT. (MONTH)  | 7     | 6        | 5     | 7     | N/A    | 11    | 5      | 6     | 6     |
| CONSUMER, AUTOMOBILE              | AVE. RATE          | 11.89 | 12.45    | 13.25 | 13.09 | N/A    | 13.00 | 11.40  | 11.83 | 12.12 |
| CONSUMER, PERSONAL                | AVE. RATE          | 15.46 | 15.92    | 16.75 | 19.79 | N/A    | 13.50 | 12.47  | 15.97 | 14.60 |
| CONSUMER, CREDIT CARDS            | AVE. RATE          | 18.18 | 18.60    | 18.00 | 19.44 | N/A    | N/A   | 19.24  | 20.18 | 16.97 |

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS.

\* DATA ARE COMPOUNDED ANNUAL RATES.